Internal Revenue Service

memorandum

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Br2:DCFegan

date: JAN 30 1989

to: District Counsel, Los Angeles CC:LA
Attention: Richard H. Gannon

from: Assistant Chief Counsel (Tax Litigation) CC:TL

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subject: [redacted]

This is in reply to your memorandum of November 17, 1988, requesting our views concerning an issue relating to the above-named taxpayer.

ISSUE

Whether a transaction constituted a sale of the assets of [redacted] or a sale of its stock.

CONCLUSION

We believe the transaction in issue was properly treated by the taxpayer as a sale of the assets of [redacted]

FACTS

This matter concerns two unrelated, three-tiered groups of affiliated corporations. The taxpayer, [redacted], was at the top of one group. It owned all the stock of [redacted], which in turn owned all the stock of [redacted]. The other group was composed of [redacted], which owned all the stock of [redacted], which in turn owned all the stock of [redacted].

The issue arises out of a cash merger in [redacted] that most directly involved the lowest tier subsidiaries in each of these groups. Specifically, [redacted] was the target company. [redacted] merged into [redacted], the surviving corporation, and the separate existence of [redacted] ended. In return, [redacted] paid $[redacted] to [redacted].

The primary documents effecting the merger were an "Agreement and Plan of Merger" (APM) executed on behalf of all six corporations and an exhibit thereto entitled "Agreement of Merger" (AM) executed only by the target and surviving corporations. The most significant provisions of these

agreements are set forth below:

> Each such Board of Directors has duly adopted and authorized this agreement and the holders of a majority of the issued and outstanding shares of each of [redacted], [redacted], and [redacted] have adopted and consented to the adoption of this agreement. (APM p. 1)
>
> The parties intend and agree that the transaction contemplated herein be treated as a sale of assets for income tax purposes. (APM p. 1)
>
> On the Effective Date, [redacted] shall be merged into [redacted], the separate existence of [redacted] shall cease, and [redacted], as the Surviving Corporation, without further action, shall possess all of the rights, privileges, powers, and franchises and shall be subject to all of the restrictions, disabilities and duties, of each of the Constituent Corporations [redacted] and [redacted]. All property, real, personal and mixed, and all debts due to either of the Constituent Corporations on whatever account, shall be vested in the Surviving Corporation, and all rights of creditors and all liens upon any property of each of the Constituent Corporations shall be preserved unimpaired. (APM p. 2)
>
> On the Effective Date, each of the [redacted] (1000) outstanding shares of [redacted] Common Stock...shall be without any further action converted into the right to receive the sum of (a) [redacted] Dollars ($[redacted]) plus (b) interest.... (APM p. 3)
>
> Upon [redacted]'s [redacted]'s] receipt of the consideration..., [redacted] will surrender certificates representing all of the issued and outstanding Common Stock of [redacted] to [redacted] for cancellation. (APM p.3)
>
> The Certificate of Incorporation of [redacted]

[redacted] in effect on the Effective Date shall continue to be the Certificate of Incorporation of the Surviving Corporation.... [AM p. 2]

The bylaws of [redacted], in effect immediately prior to the Effective Date, shall continue to be the bylaws of the Surviving Corporation.... [AM p. 2]

The directors of [redacted] immediately prior to the Effective Date shall be the directors of the Surviving Corporation.... [AM p. 2]

The officers of [redacted], immediately prior to the Effective Date, shall be the officers of the Surviving Corporation.... [AM p. 2]

The holders of the outstanding shares of [redacted] immediately prior to the Merger, on surrender to the Surviving Corporation of the certificates representing such shares, shall be entitled to receive in exchange therefor the cash to which they are entitled.... [AM p. 4]

The taxpayer reported this transaction on its consolidated income tax return as a sale of the assets of the target company (as did the surviving corporation) followed by a liquidation, and reported losses of approximately $[redacted] on the transaction. However, if the transaction is properly characterized as a sale of the target company's stock, then approximately $[redacted] of gain was generated.

DISCUSSION

Let us begin by noting that the transaction in issue is a taxable event, a sale, rather than a tax-free reorganization. For there to be a reorganization for tax purposes, the continuity of interest requirement would have to be met. That is, the owners of the acquired corporation would have to retain a substantial continuing equity interest in the business enterprise after the transaction. See Southwest Natural Gas Co. v. Commissioner, 189 F.2d 332 (5th Cir. 1951); Norman Scott, Inc. v. Commissioner, 48 T.C. 598 (1967); and Rev. Rul. 69-6, 1969-1 C.B. 104.

Here, [redacted], which owned all the stock of the target corporation, owned none of the stock of the surviving corporation. The continuity of interest requirement is not met. The transaction is not a reorganization. It is a sale.

There is little precedent as to whether a cash merger like the one in issue constitutes a sale of the target company's stock or assets. Our research, like that done before us, led us primarily to Rev. Rul. 69-6, supra, and West Shore Fuel, Inc. v. United States, 78-1 USTC ¶ 9311 (W.D. N.Y. 1978), aff'd, 79-1 USTC ¶ 9357 (2d Cir. 1979). First we will consider the revenue ruling.

Rev. Rul. 69-6 holds that the acquisition, by a federally chartered nonstock savings and loan association, of a state chartered savings and loan association having outstanding capital stock does not constitute a reorganization. The ruling concerns X, a state chartered savings and loan association having permanent shares of stock outstanding. X proposes to merge into Y, a federally chartered nonstock membership savings and loan association owned entirely by its share account holders. Each X shareholder who consents to the merger would exchange his X stock for a voting membership in the form of a voting share account of Y in an amount equal to the number of his X shares multiplied by their fair market value. Following the merger X would be dissolved.

The ruling focused on the consideration received by the X shareholders in exchange of their stock. They received share accounts in Y. Share accounts composed the entire equity interest in Y, but they also evidenced withdrawable amounts equal to the fair market value of the stock surrendered. In other words, the X shareholders received both proprietary interests in Y and withdrawable cash deposits. However, since the withdrawable amounts equaled the fair market value of the stock surrendered, only minimal value could be attributed to the proprietary interests the X shareholders received in Y. Since the proprietary rights received were insignificant in comparison to the cash equivalents received, the ruling held no reorganization took place as the continuity of interest requirement was not met.

After reaching this primary holding, Rev. Rul. 69-6 goes on to state that the transaction will be considered a sale by X of all its assets to Y. Moreover, gain or loss on this sale would be recognized to X measured by the difference between the basis of the assets transferred and the amount received from Y. No rationale for this conclusion is given.

Without going any further, consider the broad ramifications of this ruling with respect to any cash merger that the Service would be arguing should be treated as a stock sale. The Service would have to effectively distinguish the conclusion of the ruling that the transaction constituted a sale of assets. Since no rationale for the conclusion is given, that task is formidable. In other words, a broad reading of this ruling is

that cash mergers constitute asset sales and, without rationale as to why the particular cash merger in the ruling constitutes an asset sale, the Service would be hard pressed to distinguish the ruling. This is not to say Service position is that all cash mergers constitute asset sales. Rather, we believe that in the absence of limiting language set forth in the ruling, most courts would interpret the ruling broadly and it would undermine our litigating prospects.

Like Rev. Rul. 69-6, West Shore Fuel, Inc. v. United States, 78-1 USTC ¶ 9311 (W.D. N.Y. 1978), aff'd, 79-1 USTC ¶ 9357 (2d Cir. 1979), held a cash merger was a sale of corporate assets rather than a sale of stock. The issue was eligibility for installment sale treatment of gain, but the issue turned upon whether a transaction structured as a cash merger was a sale of corporate assets or of stock. Moreover, it was the Service that argued for characterization as an asset sale and prevailed at both the trial and appellate levels.

The case concerned the merger of American Steamship Corporation into Oswego Steamship Company with the shareholders of American receiving cash and notes for their American shares. American originally offered to sell its stock to Oswego, but Oswego rejected the offer. Oswego did not make tender offers to individual shareholders and individual shareholders could not elect to sell or retain their stock; individual shareholders could only vote for or against the plan of merger and liquidation. Once two-thirds of the American shareholders approved the plan, the shareholders only had a right to receive a liquidation distribution, Oswego obtained the assets of American, and American no longer existed. All negotiations were conducted between the boards of directors of the two corporations without shareholder involvement.

On these facts, the trial court found the merger had none of the usual features of a stock sale. It held the transaction more closely resembled a sale of the assets by American, than a sale of stock. The court stated it was unconcerned with how the officers of American viewed the transaction or whether it could have been structured as a stock sale. Similarly, the court was unconcerned that the American shareholders received their cash and notes from Oswego rather than from American. What seemed to influence the court was the rejection of the original stock sale proposal by Oswego and Oswego's subsequent actions in negotiating with American itself, which owned the corporate assets, rather than with the shareholders who owned the American stock.

On appeal of the case, the Second Circuit largely expressed agreement with the rationale of the trial court. In addition, the Second Circuit noted that the parties treated the transaction as a sale of the assets, even though they did not satisfy the state law requirements for consummating a sale of assets.

In addition to these two formal precedents, Rev. Rul. 69-6 and West Shore Fuel, we can expect other opinions that do not constitute formal precedents to influence a court as to the instant case. Several commentators have cited Rev. Rul. 69-6 for the proposition that cash mergers will be treated as sales of corporate assets. Ginsberg, Taxing Corporate Acquisitions, 38 Tax Law Rev. 177, 193 (1983); Levin and Bowen, Taxable and Tax-Free Two-Step Acquisitions and Minority Squeeze-Outs, 33 Tax Law Rev. 425, 465 (1978). Moreover, the taxpayer has presented the Service with a list of private letter rulings concluding particular cash mergers were sales of assets.

PLR 8337065 is an example of a letter ruling that, when the additional extraneous facts are put aside, concerned essentially the same facts as in the instant case. That is, a corporation (Oldco) was merged into an unrelated corporation (Newco) in 1983 with the Oldco stock being cancelled and the parent of Oldco receiving consideration in the form of cash and notes. Citing Rev. Rul. 69-6, the letter ruling holds,

> For federal income tax purposes, the merger of Oldco with and into Newco will be considered to be a sale by Oldco, pursuant to a plan of liquidation adopted by its shareholder, Parent, of all its assets to Newco for cash, notes, and the assumption by Newco of Oldco's liabilities, followed by the distribution to parent by Oldco of the cash and notes in complete liquidation.

We need go no further to reach our conclusion. We are not writing on a clean slate. Were that the case, we might view the characterization of this transaction as a factual matter, we might conclude there are few guideposts as to the true character of the transaction (especially where the target company is a wholly owned subsidiary corporation) apart from matters of form having no foundation in economic reality, and we might believe it worthwhile to take the position that the essential nature of this transaction was that [redacted] exchanged stock for cash.

However, regardless of how we perceive the true economic reality of this transaction, we are also faced with the reality that the precedents have universally held cash mergers to constitute asset sales. Case law, published Service position, legal commentators, and private letter rulings all hold cash mergers to be asset sales. It is true that some of the precedents should not be relied upon by the courts, but we expect those precedents would be afforded some credence anyway. It is also true that some of the facts relied upon to establish assets sales in these precedents are not present in the instant situation. Nonetheless, the overall impact of these precedents

is to create the impression that courts, commentators, and the Service alike generally have agreed to the characterization of cash mergers as asset sales. That in itself creates a nearly insurmountable litigating hazard.

Even if the Service were willing to take the position that some cash mergers are stock sales, this is not the case in which to advance that position. While there are two unusual factors relevant in determining the proper characterization of the cash merger in issue, each factor supports a different characterization. That the agreements stated that the [redacted] stock would be converted into $[redacted] per share is good evidence of a stock sale, but that the agreements expressed the intent to treat the transaction as an asset sale and that both parties abided by those agreements is good evidence of an asset sale. These two factors tend to offset each other, so that the facts concerning this particular cash merger do not favor asset sale characterization.

For these reasons, we recommend that the Service accept the taxpayer's treatment of the transaction as a sale of assets. 1/

MARLENE GROSS

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1/ Our conclusion is not altered by the enactment of section 338 of the Code as that section applies only where there is a qualified stock purchase. Here we have concluded there was solely an asset purchase.